

economic LETTER

MARCH 2014



DECLINING U.S. ENERGY DEPENDENCE AND ITS CONSEQUENCES FOR CANADA

In recent years, the United States has considerably expanded its production of natural gas and petroleum thanks to techniques—hydraulic fracturing and horizontal drilling—that make it possible to extract the gas and petroleum contained in rock formation, generally shale. The United States has been producing shale gas since the early 2000s and shale oil since 2006.

Shale oil production—concentrated in North Dakota and Texas—has allowed the United States to substantially reduce its net imports of crude oil: as a proportion of oil consumed, these have tumbled from a peak of 60% in 2005, to 40% in 2012.¹ And that is not the end of the story, since shale oil production has accelerated in recent years and, according to the U.S. Energy Information Administration (EIA), it is likely to surge from 2.3 million to 4.8 million barrels per day between 2012 and 2021. Furthermore, natural gas production, particularly shale gas, should also continue at a brisk pace in the years to come. The agency predicts that the United States will become a net exporter of natural gas starting in 2018.

According to the EIA's forecasts, the proportion of net imports of energy (oil, natural gas, coal, nuclear energy, hydroelectric energy and other energy products) in total energy consumption, which stood at 30% in 2005, will be no more than 4% in 2040. Does this mean that 26 years from now, the United States will be practically self-sufficient in terms of energy? No, far from it, because the various forms of energy are not interchangeable. For transportation, in particular, it is difficult to replace gasoline with natural gas. Consequently, in 2040, the net imports of oil by the United States will be less than in 2012, but still relatively high (Graph 1). On the other hand, Americans will then be net exporters of natural gas and other energy products.▼

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- The balance of trade improves
- Housing starts lose ground

United States

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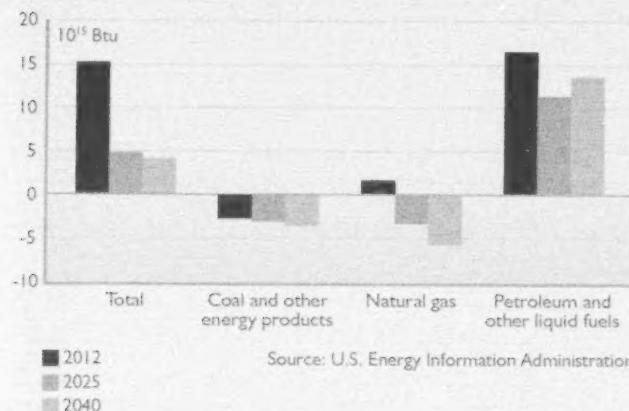
Key indicators

BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to March 8. Reliance on and use of this information is the reader's responsibility.

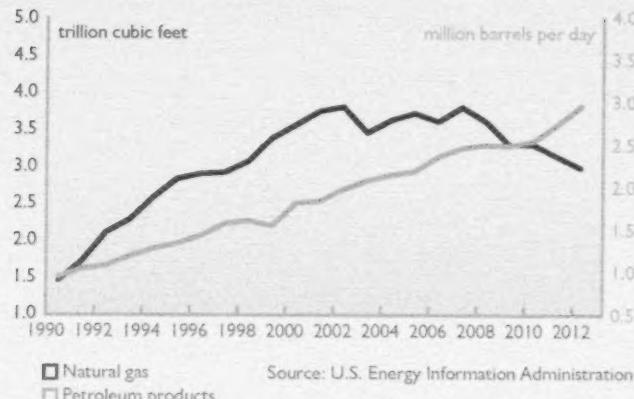
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¹ U.S. Energy Information Administration (2014), Annual Energy Outlook 2014 Early Release Overview.

Graph 1: United States – Net imports of energy products, by product



Graph 2: Imports of Canadian natural gas and oil products by the United States



The boom in American oil and gas production is not without repercussions for Canada. For example, in recent years, the United States has substantially scaled back its imports of Canadian natural gas (Graph 2) and the EIA predicts that this downward trend will continue. The increase in gas production in the United States has also driven natural gas prices down. Moreover, Canada's natural gas wells are in decline, meaning new ones need to be drilled in order to renew the reserves; this is very expensive. Due to lower prices, conventional natural gas operations have become far less profitable, and production in Canada has declined significantly.² The National Energy Board (NEB) of Canada predicts that in the years to come, the industry will exploit more tight gas and shale gas due to the lower procurement costs associated with new extraction technologies.³ Whereas in 2009, conventional gas represented at least 50% of total natural gas production in Canada, the NEB predicts that it will account for a mere 6% of production in 2035. According to the agency's scenario, the quantities of Canadian natural gas available for export will diminish between now and 2018, and then start to increase again. That being said, the NEB's projections assume that Canada will have the infrastructure to transport the gas to domestic and foreign markets, and that there will be sufficient demand for Canadian exports. Actually, nothing could be less certain, on either count. At present, Canada has no operational facilities for exporting liquefied natural gas. However, six projects were proposed in early 2013, and the NEB has issued long-term export permits to three of them.⁴

As far as oil is concerned, although they have expanded their own production, the Americans have not reduced their imports of Canadian oil (Graph 2). In fact, Canada is practically the only country whose oil exports to the United States increased in 2012 and in 2013. Geographical proximity and the healthy political relations that Canada enjoys with its neighbour make it a preferred supplier. The EIA forecasts that Canadian oil exports to the United States will keep growing.

That being said, forecasts are based on assumptions and, as far as energy is concerned, those assumptions are subject to great uncertainty. Price trends, among other things, have an enormous impact on production. The availability of infrastructure to transport the energy to market can also influence prices and, consequently, production. Environmental regulations can change. The future volumes of oil production in the United States are still very hypothetical and could advantage, or disadvantage, future oil imports from Canada.

For both natural gas and oil, Canadian exports are highly dependent on American demand. If the current trend in gas and oil production in the United States continues, Canada will need to diversify its export markets if it wants to keep taking full advantage of these resources.■

² There are many types of natural gas: conventional natural gas is that which is extracted by drilling a well; tight gas and shale gas are unconventional gases trapped in rock; coal bed methane (CBM) is trapped in coal; and dissolved gas is natural gas produced along with oil from oil wells.

³ Government of Canada (2013), National Energy Board, Canada's Energy Future 2013: Energy Supply and Demand Projections to 2035.

⁴ <http://www.nrcan.gc.ca/energie/gaz-naturel/5684>

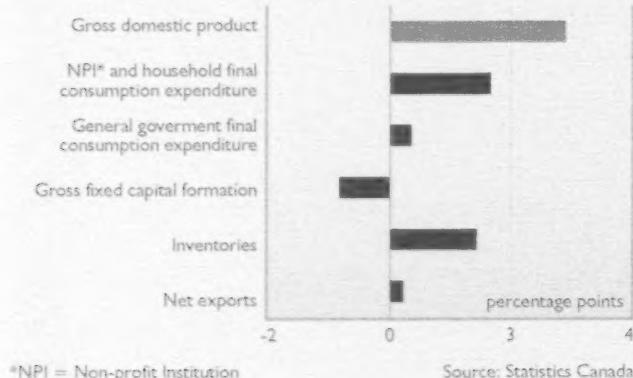
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The quarterly economic account data are disappointing as far as private investment and exports are concerned. In addition, job growth has slowed significantly in recent months. However, the firming up of the U.S. economy and the past depreciation of the Canadian dollar against the U.S. dollar should bear fruit in the upcoming quarters.

Real GDP grew by 2.0% in 2013

Real GDP contracted by 0.5% in December compared with the previous month. Production flagged in most industries, but it was the manufacturing, wholesale and retail trade and construction sectors that recorded the sharpest drops in December. For the fourth quarter, the economic accounts reported annualized real GDP growth of 2.9%, a rate similar to that of the third quarter (2.7%). Consumption and investment in inventories were the main contributors to that growth (Graph). Exports rose, but mainly in the service sector. Imports also increased, but at a slower pace than exports, so that the contribution by net exports to growth was slightly positive. The data on business investments were disappointing: only investments in machinery and equipment recorded an increase in the fourth quarter – and that came after three quarters of decline. In annual terms, real GDP grew by 2.0% in 2013 after growth of 1.7% in 2012. According to the Consensus Economics forecast, growth should reach 2.2% in 2014.

Contribution to the percent change in real GDP, fourth quarter 2013



Weak job growth

In February, a gain of 18,900 full-time jobs, combined with a loss of 25,900 part-time jobs, produced a net decline of 7,000 jobs compared with the previous month. The unemployment rate remained unchanged, at 7.0%. The largest job losses were observed in Quebec (-25,500) and British Columbia

(-10,400), while Alberta recorded the greatest gains (19,000). Job growth has clearly slowed: only 3,400 jobs have been created per month, on average, during the past six months, compared with a monthly average of 12,400 jobs in the previous six months.

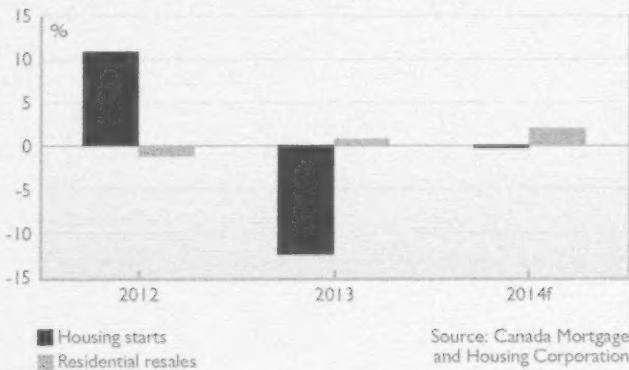
The balance of trade improves

Imports pulled back by 1.6% in January while exports expanded by 0.2%. The result is that the trade deficit shrank, from \$922 million in December to \$177 million in January. Imports from the United States were down by 1.8% and those from other countries by 1.2%. Exports to the United States dipped by 0.1% while exports to other countries rose by 1.2%. So far, the effect of the Canadian dollar's depreciation against the U.S. dollar observed in 2013 is reflected mainly in imports, whose growth has slowed in recent quarters. Its positive effect on exports south of the border is slow to materialize.

Housing starts lose ground

The total volume of housing starts fell from 187,144 units in December to 180,248 units in January. In urban centres, housing starts declined by 6.0% in the multiple-unit segment, while they rose by 3.4% in the single-family homes segment. The housing start trend, based on the six-month moving average, has been downwards for the past two months. The Canada Mortgage and Housing Corporation (CMHC) predicts that housing starts, after tumbling by 12.5% in 2013, will remain relatively stable in 2014. The CMHC believes that in some local markets, the number of homes under construction is relatively high, and therefore expects that builders will scale back their operations in order to adjust their inventories. The CMHC also expects home sales growth to accelerate, from 0.8% in 2013 to 2.0% in 2014 (Graph).■

Annual Change in Housing Starts and in Residential Resales (2012, 2013 and 2014)



Economic activity is continuing to gather steam. The job market situation keeps improving, and businesses are regaining confidence. The real estate sector is suffering a bit of a slowdown, but the harsh weather conditions that held sway during the winter are largely responsible.

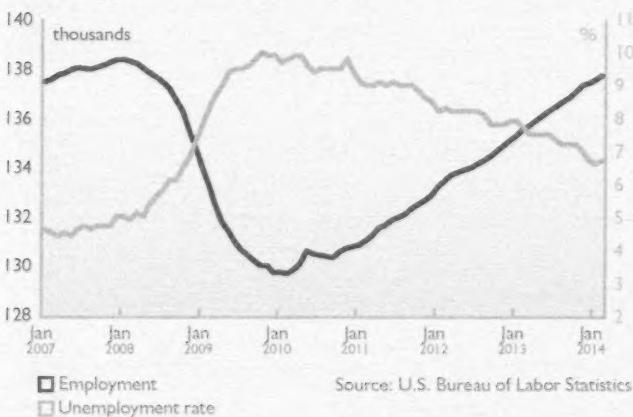
Fourth-quarter real GDP growth is revised downwards

According to the second estimate by the U.S. Bureau of Economic Analysis, based on a more complete set of data, real GDP grew by 2.4% in the fourth quarter of 2013, instead of 3.2% as originally estimated. In annual terms, real GDP growth in 2013 was 1.9%, compared with 2.8% in 2012.

The job market keeps expanding

February saw the creation of 175,000 jobs, and the data of the two previous months have been revised upwards (9,000 new jobs in December and 16,000 in January). During the previous 12 months, the average monthly job growth was 189,000. The unemployment rate edged up slightly from 6.6% in January to 6.7% in February, although the job market situation is continuing to improve. All the jobs that were lost during the recession have now been recovered, and the unemployment rate has fallen considerably (Graph). That being said, the number of discouraged workers (those who have withdrawn from the labour force because they are convinced that they will not find work) and underemployed (people who are working part-time because they have been unable to find a full-time job, or because their employer has cut their work hours) is still high, and the unemployment rate has not yet returned to its pre-recession level.

Employment and Unemployment Rate (January 2007 to February 2014)



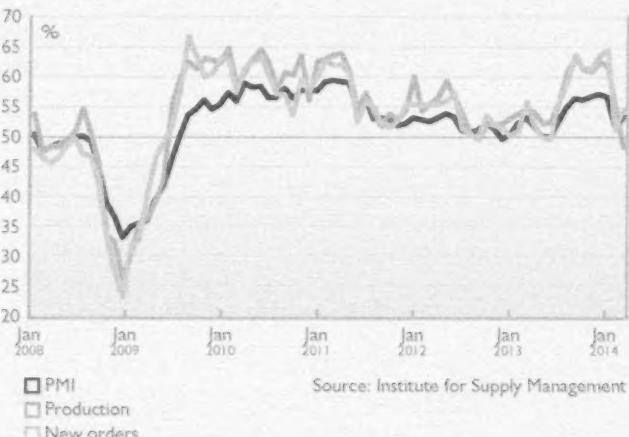
Housing starts plummet

Housing starts plunged from 1,048,000 units in December to 880,010 units in January, wiping out all the gains achieved since September 2013. The single-family segment posted a monthly drop of 15.9%, while the multiple-unit segment fell by 12.8%. The overall housing start trend, measured by the six-month moving average, levelled off in January after heading up in recent months. Meanwhile, home sales declined by 5.1% in January to reach an 18-month low. According to the chief economist at the U.S. National Association of Realtors, inclement weather did damage to the real estate market in recent months, but other factors behind the slowdown are tighter credit, low inventory and higher home prices and mortgage rates.

Business confidence picks up

The manufacturing purchasing managers' index compiled by the Institute for Supply Management was up by 1.9 percentage points in February, reaching 53.2%, thus winning back some of the ground that was lost in the previous month. The new orders sub-index advanced, but the production sub-index pulled back and even fell below the 50% mark, indicating a decline in output, the first in 17 months (Graph). However, the sub-indexes vary considerably from one month to the next, so the February numbers should be interpreted with caution. ■

Manufacturing Purchasing Manager Index (January 2008 to February 2014)



The key interest rate remains unchanged

As expected, the Bank of Canada left the target for the overnight rate unchanged on March 5. The central bank still believes that inflation will remain below 2% in 2014 due to the excess supply in the Canadian economy and competition

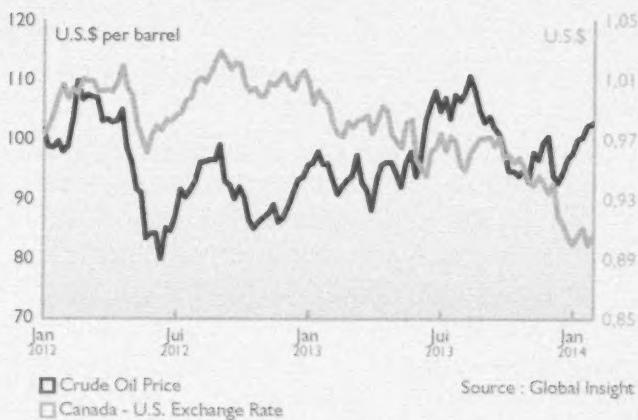
in the retail sector. It also notes that exports are disappointing and that the recovery in business investment is overdue. In these conditions, the trendsetting interest rate will no doubt remain static in 2014, as expected by the consensus forecasts.■

OIL AND THE LOONIE

The price of oil climbs, the Canadian dollar stabilizes

The deployment of Russian armed forces in Crimea, in the south of Ukraine, drove the price of oil up to a four-month high, reflecting fears that Russian exports could be blocked if the situation deteriorates. Russia is the second largest crude oil producer in the world, exporting nearly 5 million barrels per day. It is also the second largest producer of natural gas, and its exports to Europe transit through Ukraine. As for the Canadian dollar, which depreciated by 12% between September 2012 and January 2014, it remained stable in February, hovering around US\$0.90.■

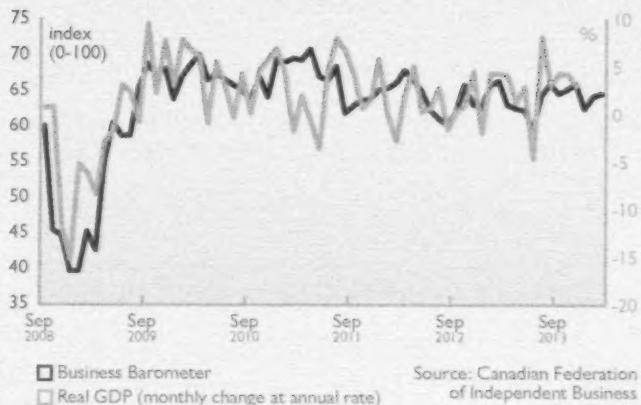
Exchange Rate and Crude Oil Price
(January 2012 to February 2014)



SME confidence firms up

The Business Barometer Index compiled by the Canadian Federation of Independent Business (CFIB) rose 0.4 percentage points to reach 64.4 (Graph). Owners of SMEs in the agricultural sector seemed to be the least optimistic; at the other end of the spectrum, business leaders in the information, arts and recreation sector, and those in the business services sector, showed the greatest optimism. From a regional perspective, British Columbia and Alberta had the highest indexes, while those of New Brunswick and Nova Scotia were at the back of the pack. According to the CFIB, hiring intentions were fairly positive for this time of year, with 25% of business owners planning to recruit full-time staff in the next three or four months, and just 6% considering layoffs.■

GDP and Business Barometer
(September 2008 to February 2014)

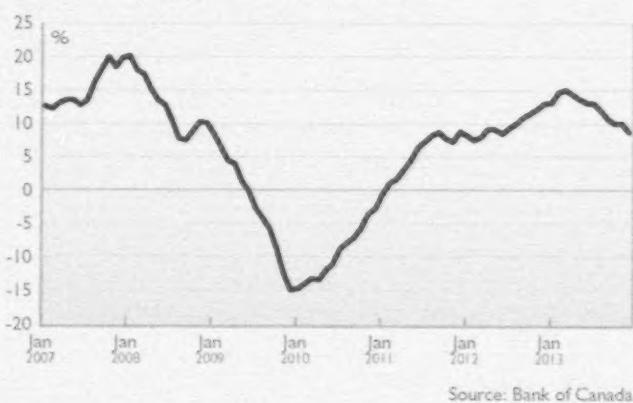


\$ BUSINESS CREDIT CONDITIONS

Slower growth in bank credit granted to businesses

In December 2013, short-term credit granted to businesses by the chartered banks rose by 3.7% from the previous month, and long-term credit by 5.9%. Growth in bank credit slowed considerably during the past year, as shown by the graph below. The 12-month variation tumbled from a peak of 15% in March 2013 to 8.8% in December 2013. Yet the effective interest rate for businesses remained relatively stable during that period, at around 3.3%. On the other hand, private business investment did not increase much in 2013, which could account, at least in part, for the slower growth in bank credit.■

Business Credit from Chartered Banks
(12-month change, January 2007 to December 2013)



KEY INDICATORS – CANADA

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Key indicators – Canada

	Historical ¹				2013 ²				Latest	Forecast	
	2009	2010	2011	2012	Q1	Q2	Q3	Q4		2014	2015
Real GDP (% growth)	-2.7	3.4	2.5	1.7	2.9	2.2	2.7	2.9	Dec	-0.5	2.2
Machinery and Equipment Expenditures (% growth)	-21.2	10.6	8.6	5.2	-0.7	-0.4	-4.3	3.2		4.3	6.0
Pre-Tax Corporate Profits (% growth)	-45.4	61.6	16.6	-8.2	25.7	-28.0	36.1	5.7		5.5	5.8
Industrial Production (% growth)	-11.0	6.0	3.9	0.9	6.9	-2.8	2.6	5.5	Dec	-0.9	2.3
Industrial Product Prices (% growth)	-3.5	1.0	4.6	0.6	4.5	-1.0	1.6	-16.9	Jan	0.0	1.4
Non-Residential Construction (% growth)	-19.4	17.3	12.9	6.9	2.8	-1.0	2.6	-4.0			
Housing Starts ('000 units)	148	191	193	215	170	190	195	195	Jan	180	179
Personal Expenditures (% growth)	0.3	3.5	2.3	1.9	1.0	3.5	2.4	3.1		2.2	2.2
Consumer Price (% growth)	0.3	1.8	2.9	1.5	1.6	-0.1	1.9	-0.9	Jan	0.3	1.4
Employment (% growth)	-1.6	1.4	1.5	1.2	0.9	1.2	0.8	0.9	Feb	0.0	
Unemployment Rate (%)	8.3	8.0	7.4	7.3	7.1	7.1	7.1	7.0	Feb	7.0	6.9
SMEs Confidence Index (CFIB)	57.7	66.7	66.4	63.9	64.9	61.3	64.8	64.4	Feb	64.4	
Manufacturers Confidence Index (CFIB)	56.0	68.5	67.3	66.7	65.6	58.3	65.4	65.8	Feb	66.4	

1. Annual growth rate
2. Quarterly growth, at annual rate
3. Month-over-month growth

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business.



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